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THE ROLE OF THE COMMITTEE IN 363 SALES

The statutory creditors' committee, the authors argue, has an important role to play in Section 363 sales to protect the interests of unsecured creditors, particularly when the prospective buyer is also a DIP lender. The authors discuss important issues for the committee in three phases: protections provided the DIP lender in the financing phase; bid protections in the sale process; and concerns in the sale and purchase agreement phase.

By Mark S. Indelicato and Alison M. Ladd *

Section 363 of the Bankruptcy Code authorizes a debtor, "after notice and a hearing, [to] sell, or lease, other than in the ordinary course of business, property of the estate…."[1] Chapter 11 debtors have increasingly utilized Section 363 to pursue rapid sales of all or substantially all of their assets early in the chapter 11 cases, outside of a traditional plan process. Thus, statutory creditors' committees (the "Committee") must play an active role in Section 363 asset sales to protect the interests of unsecured creditors who do not have the same statutory protections in a Section 363 sale that are afforded to such creditors in a chapter 11 plan process and are often at a disadvantage to other constituents in the case, such as the debtor's secured lender(s).

The typical challenges faced by the Committee in a Section 363 sale are significantly compounded when the proposed purchaser of the debtor's assets ("Stalking Horse Bidder") is also providing the debtor-in-possession financing ("DIP Financing") — whether it be a pre-petition lender who plans to credit bid for the debtor's assets, or a third-party purchaser who intends to provide DIP Financing to stabilize the debtor's operations through consummation of the sale. In these instances, the protections provided to the proposed debtor-in-possession lender ("DIP Lender") pursuant to the terms of the DIP Financing order ("DIP Order") are designed not only to provide benefits as a DIP Lender, but to also provide benefits as purchaser (*e.g.*, cross-default provisions, abbreviated sale timeline, generous fees, and expense reimbursement provisions, etc.). As a result, when the DIP Lender is also the Stalking Horse Bidder, the intersection of the DIP Order and order approving the bidding procedures for the debtor's assets ("Bid Procedures Order") can present unique challenges for both the Committee and the court.

For example, a third-party DIP Lender that seeks truncated sale milestones in the DIP Order to expedite payoff of the DIP Financing is often problematic for the Committee, given that an extended sale process is generally more likely to bring additional purchasers to the table. However, when the DIP Lender is also the Stalking Horse Bidder, the rapid sale timeline set forth in the DIP Order backs the Committee into a corner, and gives the DIP Lender/Stalking Horse Bidder unreasonable control over the entire sale process and the ability to limit or even eliminate competitive bidding. While there is no simple solution to this issue and the numerous others that arise when the DIP Lender is also the Stalking Horse Bidder, the over-arching

[1] 11 U.S.C. § 363(b)(1).

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consideration for the Committee and the court is whether the DIP Order and the Bid Procedures Order (and the respective protections provided therein) be viewed in isolation or considered together as one global integrated transaction. Namely, when confronted with a DIP Lender who is also the Stalking Horse Bidder:

1. Should heightened scrutiny be applied by the court when reviewing the lender protections sought in the DIP Order to the extent they might also affect the sale process (*e.g.*, unlimited credit bidding rights, broad expense reimbursement provisions, unreasonably tight sale milestones, etc.)? and

2. Should the lender protections granted to the Stalking Horse Bidder in the context of the DIP Order (*e.g.*, reimbursement of fees incurred in any context related to the bankruptcy) be taken into consideration by the court when awarding bid protections in the context of the Bid Procedures Order?

We discuss these issues below.

PHASE I – DIP FINANCING

With many chapter 11 cases on the fast track to a Section 363 asset sale, the Committee's fight to protect unsecured creditors' interests often begins on day one of the case in connection with the debtor's proposed DIP Financing. Specifically, the protections provided to the DIP Lender in the proposed DIP Order can present a number of landmines for unsecured creditors, particularly when the DIP Lender is also the Stalking Horse Bidder for the debtor's assets. Thus, the Committee should be on the lookout for the following recurring issues.

Assessment of the Need for DIP Financing

One of the first tasks for the Committee following its appointment will be to analyze, with the assistance of its professionals, whether DIP Financing is necessary to stabilize the debtor's business operations through consummation of a Section 363 sale or, instead, an attempt by a pre-petition lender to rollup and/or cross-collateralize its pre-petition secured obligations or part of an aggressive loan-to-own strategy that will enable the DIP Lender to obtain leverage over the sale process.

For example, in several recent bankruptcy cases in Delaware, the pre-petition lenders (who were also the stalking horse bidders) provided DIP Financing that appeared to provide the debtors in question with financing in excess of the amount that was needed to fund the debtors' operations prior to closing. In these cases, the committees argued that this excess DIP Financing was not needed to operate the debtors' businesses but instead would be used by the respective stalking horse bidders as additional funding to satisfy its assumed obligations under the respective asset purchase agreements. This structure enabled the proposed purchasers to have the debtors' estates pay for a portion of the purchase price at the inception of the case by providing the excess DIP Financing, effectively reducing the amount of capital the purchasers would be required to invest at closing.[2] It also gave the purchasers an edge in the bidding process because it required any alternative bidder to start bidding at a higher purchase price.

In these cases, the excess DIP Financing was just one of a multitude of issues that the committees had with respect to the debtors' proposed DIP Financing and bid procedures, which were ultimately resolved globally. These negotiated settlements included the consensual resolution of certain issues, and either the establishment of a fund to provide a distribution to unsecured creditors and/or a reservation of the unresolved issues for later in the case when the magnitude of the funds in dispute would be crystalized.

Limiting the Lender's Right to Credit Bid

In order to gain additional leverage, a DIP Lender/Stalking Horse Bidder will seek a clear finding that it has an absolute right to credit bid the full amount of its claim, while at the same time, attempt to limit or otherwise curtail a Committee's right to challenge the amount, priority, and extent of its liens (perhaps by limiting the professional fee carve-out) to otherwise solidify its right to credit bid.

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[2] The DIP Lender/Stalking Horse Bidder can achieve this modification to the purchase price by either receiving a credit against the purchase price for a DIP that is not fully funded or by utilizing the excess availability under the DIP to satisfy cash obligations under the APA if cash is a purchased asset.

Section 363(k) of the Bankruptcy Code provides that a secured creditor may bid in the full amount of its allowed claim with respect to a Section 363 sale of the collateral that secures the creditor's claim.[3] Given that the debtor may sell its assets free and clear of valid liens under Section 363(f), credit bidding under Section 363(k) "ensures that, if the bidding at the sale is less than the amount of the claim the collateral secures, the secured creditor can, if it chooses, bid up the price to as high as the amount of its claim."[4] However, this right is not absolute as the secured creditor's right to credit bid exists "unless the court for cause orders otherwise."[5] The term "cause" under Section 363(k) is not defined in the Bankruptcy Code and courts have traditionally been hesitant to limit a secured creditor's right to credit bid absent inequitable conduct.[6] However, recent case law suggests a broader reading of "cause" in Section 363(k) and an increasing willingness by courts to scrutinize the secured creditor's right to credit bid based upon aggressive loan-to-own tactics and the chilling effect that credit bidding may have on a competitive bidding process.[7]

For example, in *In re Fisker Automotive Holdings*, the Bankruptcy Court for the District of Delaware limited the senior secured lender's right to credit bid to the amount paid for the claim in order to promote a competitive bidding process. Specifically, the Court stated "the 'for cause' basis upon which the Court is limiting Hybrid's credit bid is that bidding will not only be chilled without the cap; bidding will be frozen."[8]

[3] 11 U.S.C. § 363(k) ("At a sale under [Section 363(b)] of property that is subject to a lien that secures an allowed claim, *unless the court for cause orders otherwise* the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.") (emphasis added).

[4] *Quality Props. Asset Mgmt. Co. v. Trump Va. Acquisitions, LLC*, 2012 U.S. Dist. LEXIS 115225 (W.D. Va. Aug. 16, 2012).

[5] 11 U.S.C. § 363(k); *see also In Re Phila. Newspapers, LLC,* 599 F.3d 298, 315-16 (3d Cir. 2010).

[6] *See generally In re RML Dev., Inc.*, 528 B.R. 150, 155 (Bankr. W.D. Tenn. 2014).

[7] *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55, n. 14 (Bankr. D. Del. 2014) ("A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."); *see also In re Free Lance-Star Publ'g Co. of Fredericksburg VA*, 512 B.R. 798, 805 (Bankr. E.D. Va. 2014); Selbst, *Credit Bidding After Fisker,* 31 Rev. Bank. & Fin. Serv. 137 (Dec. 2015)(discussing cases).

[8] 510 B.R. at 60.

Similarly, in *In re Free Lance-Star Publishing Co. of Fredericksburg VA*, the Bankruptcy Court for the Eastern District of Virginia held that the "confluence of (1) DSP's less than fully secured lien status; (2) DSP's overly zealous loan-to-own strategy; and (3) the negative impact DSP's misconduct has had on the auction process has created the perfect storm requiring curtailment of DSP's credit bid rights."[9]

As a result, the Committee must carefully examine the secured creditor's role in the case as Stalking Horse Bidder when evaluating any DIP Order that grants the secured lender an absolute right to credit bid the full amount of its claim. Similarly, the language granting the secured lender the right to credit bid should be tailored to ensure that the secured creditor is not entitled to credit bid on any assets for which it has no lien. Permitting a secured lender to credit bid for its own collateral plus certain unencumbered assets of the debtor's estate without providing separate additional consideration for such assets would expand the reach of the secured creditor's lien to the detriment of the estate and its unsecured creditors.

Sufficiency of Challenge Period

Whether the pre-petition lender/DIP Lender is the Stalking Horse Bidder or an independent third-party lender, the Committee must ensure that the DIP Order provides for a sufficient challenge period to investigate the validity, scope, and priority of the pre-petition secured creditor's liens. However, when the pre-petition lender/DIP Lender is also the Stalking Horse Bidder, the DIP Order may improperly seek to compress the challenge period to reduce the Committee's ability to investigate and challenge the lender's right to credit bid in connection with the Section 363 sale. Given the critical importance (discussed above) of ensuring that (1) the secured creditor has an absolute right to credit bid its allowed claim and (2) the secured creditor is not credit bidding on any unencumbered assets, the challenge period must be sufficiently long to enable the Committee to effectively complete its investigation of the pre-petition lender's liens coupled with a meaningful reservation of the Committee's (or other appropriate party's) right to preserve any challenge if the investigation cannot be completed before the sale. In fact, the Bankruptcy Court for the District of Delaware has enacted a local rule requiring a *minimum* 60-day challenge period in recognition of the critical importance of a sufficiently long investigation period.[10]

[9] 512 B.R. at 807.

[10] Del. Bankr. L.R. § 4001-2(a)(i)(B).

Extending Sale Milestones in DIP Order

When the DIP Lender is the Stalking Horse Bidder, the DIP Order will often provide for compressed sale milestones which must be met to prevent a default under the DIP Financing. These abbreviated sale timelines are often not only designed to ensure repayment of the DIP Financing, but also to preclude competitive bidding for the debtor's assets and ensure a rapid sale to the DIP Lender/Stalking Horse Bidder at the lowest price possible. Thus, in addition to challenging such milestones in connection with the Bidding Procedures Order (see below), they should be removed or modified as material terms of the DIP Financing, as it is the DIP Order which is often chronologically first in the chapter 11 case and once these deadlines are established in the DIP Order they are difficult to modify.

Limiting the Scope of DIP and Adequate Protection Liens

A typical DIP Order will grant (1) the DIP Lender liens on substantially all of the debtor's assets and a super-priority claim against the estate to secure the debtor's obligations under the DIP Financing and (2) the debtor's pre-petition lender (whether it be the DIP Lender or a third-party pre-petition lender) adequate protection liens and claims to secure the payment of an amount equal to the diminution in the value of the pre-petition lender's interests in their pre-petition collateral after the petition date.[11] However, the Committee must ensure that the DIP Order does not grant DIP liens and/or adequate protection replacement liens on any of the debtor's previously unencumbered collateral, including any obligations incurred by the debtor pursuant to chapter 5 of the Bankruptcy Code. A grant of liens to the debtor's secured creditors on avoidance actions is inconsistent with the intent behind avoidance actions, which is to allow the debtor-in-possession to recover certain payments on behalf of all creditors.[12] Thus, the DIP Order should explicitly carve out any avoidance actions and other unencumbered assets (*e.g.*, debtor's interest in its leaseholds, debtor's equity in its foreign subsidiaries, commercial tort claims, etc.) from the DIP collateral to preserve the value of such assets for the benefit of the debtor's unsecured creditors.

No Marshaling Waiver

The Committee should preserve its right to marshal the debtor's assets in the DIP Order to the extent the DIP Lender is also the debtor's pre-petition lender. The doctrine of marshaling "rests upon the principle that a creditor having two funds to satisfy his debt, may not by his application of them to his demand, defeat another creditor, who may resort to only one of the funds."[13] In order to invoke the doctrine of marshaling, a creditor must establish that: (1) two persons are creditors of the same debtor; (2) that there are two funds belonging to that debtor; and (3) one creditor alone has the right to resort to both funds.[14] While some courts have only applied the doctrine of marshaling in cases of secured creditors, several courts have held that unsecured creditors can invoke the doctrine of marshaling as well.[15] In addition, several courts have held that a trustee, endowed with the status of a secured creditor, may utilize the equitable doctrine of marshaling to marshal the assets of a secured creditor.[16] As the Bankruptcy Code vests the trustee "with the rights and powers of an unsatisfied execution creditor,"[17] the trustee exercises the "rights and powers" conveyed to such a creditor under state law.[18]

Absent a reservation of rights to compel the secured lender to marshal — that is, seeking recovery on its debt first from its pre-petition collateral and only seeking recovery from previously unencumbered assets to the extent its pre-petition collateral is not sufficient to satisfy its obligations in full — the challenge period granted to

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[11] In addition to the traditional adequate protection liens, DIP Lenders in the more aggressive loan-to-own scenarios are seeking additional and unique forms of adequate protection to otherwise buttress their position as purchaser (*i.e.*, seeking approval of payments to subordinate lenders who support them in the sale process).

[12] *Buncher Co. v. Official Comm. Of Unsecured Creditors of GenFarm Ltd. Pshp. IV*, 229 F.3d 245, 250 (3d Cir. 2000) ("[w]hen recovery is sought under section 544(b) of the Bankruptcy Code, any recovery is for the benefit of all unsecured creditors, including those who individually had no right to avoid the transfer.").

[13] *Sowell v. Federal Reserve Bank*, 268 U.S. 449, 456-457 (1925).

[14] *See In Re Computer Room, Inc.*, 24 B.R. 732, 734 (Bankr. N.D. Al. 1982).

[15] *In re Suwannee Swifty Stores, Inc.*, 2000 Bankr. LEXIS 2005, *10-11 (Bankr. M.D. Ga. Mar. 22, 2000) (holding that unsecured creditor could assert a marshaling claim but denying marshaling on other grounds); *In re Maddox*, 84 B.R. 251, 258 (Bankr. N.D. Ga. 1987) (allowing a party who was not a creditor but who had an interest in part of the debtor's property to utilize the doctrine of marshaling).

[16] *In re Tampa Chain Co. Inc.*, 53 B.R. 772, 777 (Bankr. S.D.N.Y. 1985).

[17] 11 U.S.C. § 544(a)(2).

[18] *In Re Tampa Chain Co. Inc.*, 53 B.R. at 777.

the Committee in the DIP Order may have little or no value.

Limiting Fees and Expenses of DIP Lender

The Committee must always assess the reasonableness of the DIP Lender's fees and expenses sought in connection with the DIP Financing. However, when the DIP Lender is also the Stalking Horse Bidder, the Committee must closely analyze the DIP fees and expenses in light of the totality of the circumstances. Namely, there has been a trend in recent Section 363 cases to use fee and expense reimbursement provisions in DIP Orders to provide existing lenders with an edge in the sale process.

For example, to the extent the DIP Lender in this scenario is granted reimbursement of all fees and expenses associated with the chapter 11 case (either as part of the DIP Financing or as an adequate protection claim), this right could include all fees and expenses associated with the proposed Section 363 sale even if such party is the successful purchaser, clearly giving the DIP Lender an advantage in the sale process. The same scenario could apply to junior lienholders who receive reimbursement of all fees and expenses of their professionals as a part of any adequate protection package provided to them in the DIP Order, particularly if they are supportive or otherwise part of the sale process. Therefore, the DIP Order should be modified to make it clear that the lenders are only reimbursed for actual costs associated with the DIP Financing and not those incurred in connection with the sale process.

PHASE II: THE SALE PROCESS

Once the Committee has negotiated the best possible DIP Order to preserve value for unsecured creditors, it must turn its focus to the protections granted in the Bid Procedures Order to ensure that the Stalking Horse Bidder does not have an unfair competitive advantage in the sale process. As previously stated, it may be appropriate for the court to consider the protections provided to the DIP Lender/Stalking Horse Bidder in the DIP Order when faced with a request to approve bid protections in the Bid Procedures Order. Bid protections must be reasonable and necessary to incentivize the bidder to enter the auction, which may not be the case for a Stalking Horse Bidder that is also the DIP Lender.[19]

Limiting Bid Protections for the Stalking Horse Bidder

The reasonableness of the bid protections sought by the Stalking Horse Bidder in a Section 363 sale is of paramount concern for unsecured creditors. As a general proposition, the Committee must examine both (1) whether the bid protections are warranted in the first place and if so (2) whether the amounts of the proposed bid protections are reasonable in light of the circumstances.

For example, in the Third Circuit, the awarding of the bid protections is subject to a heightened "benefit to the estate" standard.[20] Thus, in instances where there are multiple interested bidders who have already conducted due diligence and submitted competitive bids, the bid protections would not be necessary to induce bidders to enter the auction, and instead, would only serve to chill the competitive process. Moreover, even if bid protections are warranted, the proportionality of the break-up fee and expense reimbursement must be viewed in light of the size and complexity of the transaction.[21]

To the extent that the Stalking Horse Bidder is also the DIP Lender, any proposed bid protections should be

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[19] *See, e.g., In re O'Brien Envtl. Energy,* 181 F.3d 527, 535 (3d Cir. 1999) ("[T]he allowability of break-up fees, like that of other administrative expenses, depends upon the requesting party's ability to show that the fees were actually necessary to preserve the value of the estate."); *In re Reliant Energy*

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Channelview LP, 594 F.3d 200, 206 (3d Cir. 2010) ("[A] break-up fee is not 'necessary to preserve the value of the estate' when the bidder would have bid even without the break-up fee."); *In re RathGibson, Inc.,* Case No. 09-12452 (CSS) (Bankr. D. Del. Mar. 23, 2010) Hr'g Tr. 31:10-14 ("The problem with the fee — the break-up fee and the expense reimbursement isn't the amount it is the parties to whom it benefits. It is the bidders. These are DIP bidders. These are pre-petition lenders. They have been involved in the case."); *In re The Standard Register Co.*, Case No. 15-10541 (BLS) (Bankr. D. Del. April 13, 2015) Hr'g Tr. 106 ("I am not prepared to approve a break-up fee in the context of these proceedings…I am not satisfied that it's either appropriate or necessary to incentivize [a significant existing creditor] to take this initial step.").

[20] *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d at 533; *see also In re Reliant Energy Channelview, LP*, 594 F.3d at 206 (affirming the decision of the Delaware Bankruptcy Court not to authorize payment of a break-up fee to the stalking horse bidder, where there was another bidder willing to go forward at the auction without those protections, because the fee was not necessary to preserve the value of the estate).

[21] While dependent of the facts of circumstances of each particular case, courts have considered a break-up fee of up to 3% reasonable.

viewed in light of the additional sale protections provided to the DIP Lender in the DIP Order. For example, if the DIP Lender is entitled to reimbursement of all its fees in the bankruptcy without regard to the nature of the expenses, should they also be entitled to a break-up fee as Stalking Horse Bidder? Perhaps not since bid protections are designed to entice the Stalking Horse Bidder to enter the bidding process first and subject its bid to the competitive process, which may not be necessary when the Stalking Horse Bidder is also the DIP Lender and receiving protections and fees under the DIP Order. In this instance, the bid protections cannot simply be viewed as part of a separate sale transaction. Instead, the total package of protections awarded to the Stalking Horse Bidder (including previously awarded DIP fees and expenses reimbursement) must be viewed as a global transaction that may be unreasonable and operate to chill, if not completely freeze, bidding.

Extending the Sale Timeline

The Committee's primary objective in the context of a Section 363 sale is to encourage a robust marketing period and competitive auction process that will maximize the sale price for the debtor's assets. Thus, as an initial matter, the Committee must review the scope and length of the debtor's pre-petition marketing efforts to determine if the proposed sale timeline in the chapter 11 case is reasonable. An appropriate sale process is likely to bring additional parties to the table who focus on distressed asset sales, as these parties likely would not have participated in pre-petition due diligence related to the sale of the debtor's assets outside of bankruptcy. In light of this reality, the Committee must consider whether the truncated sale process, either in the DIP agreement or the Bid Procedures Order, is being motivated by the Stalking Horse Bidder's desire to limit competitive bidding on the assets or instead by legitimate economic and market conditions (*e.g.*, the seasonality of the debtor's business or severe liquidity constraints on the debtor).

Structure of the Bids

Lastly, the Committee, with the assistance of its professionals, must analyze the debtor's business to determine if the sum of the parts is greater than the whole. For example, the liquidation of a retailer's inventory plus the sale of its real property may be greater than its going concern value. If the sum of the parts has potentially greater value than the whole of the business enterprise, the Committee must ensure that the Bid Procedures Order and the DIP Order enable parties-in-interest to bid for only a portion of the debtor's assets in addition to the entire business as a going-concern.

PHASE III: THE SALE AND THE ASSET PURCHASE AGREEMENT

Aside from its critical role in ensuring a fair and open sale process, the Committee also plays an important part in the negotiation of the asset purchase agreement and consummation of the sale. While each Section 363 sale raises distinctive issues stemming from the nature of the debtor's business and the structure of the sale, some recurring questions that the Committee should consider in connection with the agreement are:

1. If the Stalking Horse Bidder is the DIP Lender, are there issues related to how the purchase price is being funded (*i.e.*, is the purchaser using the debtor's own cash to satisfy the purchase price)?
2. Who is responsible for paying employee related expenses for the individuals continuing their employment with the purchaser?
3. Who is responsible for paying cure claims and administrative priority claims arising under Section 503(b)(9) of the Bankruptcy Code?
4. Who is responsible for establishing and funding the debtor's wind-down budget (*i.e.*, how will the debtor be able to continue to operate the chapter 11 case once the sale closes)?

CONCLUSION

As detailed above, the Committee plays an integral role in Section 363 sales. From the negotiation of the DIP Order through the closing of the sale, a thoughtful and active Committee ensures a fair and open sale process that will maximize recovery for unsecured creditors. The critical importance of the Committee's oversight of the sale process is highlighted by the unique legal and practical issues that arise when the DIP Lender is also the Stalking Horse Bidder for the debtor's assets. While each case is unique, given the interplay of the BidProcedures Order and the DIP Order in this scenario, it may be appropriate for the court to evaluate these orders (and the protections sought therein) as one global integrated transaction under the prevailing standards of that particular jurisdiction. Moreover, the determination of whether courts will employ a "heightened scrutiny" standard in evaluating the reasonableness and appropriateness of these orders will depend not only on the facts and circumstances of the particular case, but also the issues and concerns expressed by the Committee. ■